Where is the light at the end of the tunnel?

We’ve made it through March, the 13th month of this recession. If the recession lasts into May, it will be the longest since the Great Depression. Is anyone having fun yet?

By this point in a typical recession, economists start noticing glimmers of light at the end of the tunnel, as some economic indicators begin to turn positive. One of the strongest indications is when the number of initial claims for unemployment insurance starts declining. In addition, manufacturing begins to perk up, housing starts begin to rise and the index of consumer confidence shows signs of life.

But so far, very little is glimmering. Weekly unemployment claims have fallen slightly since late February, but they’re still well above 600,000 and higher than at any time since 1982. Also in February, consumer confidence hit another all-time low and industrial production fell further.

And housing? I don’t think anyone expects that industry to lead us out of this recession. Both existing-home sales and housing starts rose in February, but the former was largely due to sales of repossessed homes permitted. This sets the “cap.” The government first determine the maximum amount of carbon emissions permitted. This sets the “cap.” The government would then auction off “allowances” to companies that emit carbon. An allowance is a permit to the owner to re-release a certain amount of carbon into the atmosphere. Allowances would be tradable and their value would fluctuate based on changes in demand. The government would allow market conditions to determine how much it costs to emit carbon.

The budget projects that money brought in from auctioning allowances will provide enough revenue to fund $15 billion in “clean energy technologies” and $80 billion in tax credits for working families annually through 2019. This would wean us from our current dependence on foreign oil and provide much-needed tax relief to middle- and lower-income families. Sounds good so far.

But there are major downsides to the proposal. First, cap-and-trade will cause a significant increase in energy costs. Carbon emitters will pay for allowances by passing the cost through to consumers. Who will be purchasing the allowances? Among others, utility providers. This means that we can expect to see significant increases in our electricity bills.

The Obama administration acknowledges this problem and responds by pointing to the annual $80 billion in tax credits that it intends to return to taxpayers as a way of mitigating the increased energy costs. This is called revenue recycling. The government institutes a policy that results in an increased cost to consumers, but then returns at least some of that increased cost in the form of a tax break. The question is whether the tax break will match the cost increase.

A second major problem is complexity. The cap-and-trade system requires that the federal government establish a totally new regulatory regime. This regime will have to combine technical monitoring (to make sure emitters don’t exceed their permitted allowances) with securities regulation (to oversee trading of the allowances). In effect, allowances are like tradable securities, only more complicated. Given the government’s recent performance in this area, I think we can have total faith that a new regulatory regime will succeed?

The government should dump the cap-and-trade proposal and simplify. Cap-and-trade is really just a tax wrapped up in the green politically palatable jargon of “market-driven” regulation. If the government needs to reduce carbon emissions, then it should be honest with taxpayers and simply enact a carbon tax. A tax could be structured to bring the right signals to the market as cap-and-trade and would eliminate the unnecessary bureaucracy and uncertainty inherent in creating a trading system.

Unfortunately, taxes aren’t politically feasible. That’s why we’re likely to be saddled with another bloated and ineffective regulatory agency to monitor a new cap-and-trade system. We can only hope that when it comes to regulating the system, the government’s past performance is no indication of future results.

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